No. 15399

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

EDWARD POOL and LOTTIE POOL, EDWARD POOL, LOTTIE POOL, WILLIAM K. MURPHY, EDNA MURPHY, WILLIAM K. MURPHY and EDNA MURPHY,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petitions for Review of the Decisions of the Tax Court of the United States.

REPLY BRIEF FOR THE PETITIONERS.

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ARGUMENT.

The Commissoner's Brief Does Not Meet the Issues Presented by This Appeal.

1. Several preliminary observations concerning the Commissioner's brief seem to be appropriate. Instead of dealing with the issues presented by this appeal and the serious arguments raised in our opening brief, the Commissioner's brief largely reasserts the Tax Court's disjointed marshaling of facts (both material and immaterial) as though this necessarily proved the validity of the Tax

Court's conclusion that these taxpayers were in the business of and were selling property to customers in the ordinary course of that business. All of this is done, as indeed the Tax Court did, without the slightest clue as to why a given fact is material to the application of the plain Congressional purpose expressed in Section 117(j) of the Internal Revenue Code of 1939.

The Commissioner's brief (p. 31) characterizes our legal arguments as "specious." Both such a broad side characterization of fully documented arguments neither sheds light on the important issues presented by this appeal, nor demonstrates, indeed, that the arguments are specious. Nor do we thing the validity of the Tax Court's analysis or its findings are established by the Commissioner's stating, as he repeatedly in effect does, that they are correct *because* the Tax Court said so.

Finally, we must call the Court's attention to the fact that the Commissioner's brief often cites cases for propositions that the cases do not support.

Without any attempt to deal with the Commissioner's arguments comprehensively, because to do so would unduly extend this reply, we will illustrate what we have been saying with a few important examples.

2. Our opening brief dealt at length with the proposition that a purpose of acquiring and holding property for "investment" until a decision to sell is made, is the first requirement for the applicability of Section 117(j) (Op. Br. pp. 27-35), because as this Court stated in

Rollingwood Corp. v. Commissioner, 190 F. 2d 263, 266-267, the purpose of the section is to give capital gain to " 'investment property'[1] as distinguished from 'stock in trade' or property *bought and sold* for a profit." (Italics supplied.)

We also pointed out that in the present case the Tax Court made no finding at all on this vital point (Op. Br. pp. 31-32) and that this Court reversed in *McGah v. Commissioner,* 193 F. 2d 662, *solely* because of a similar failure. The Tax Court did state in its opinion that Pool had an investment purpose (and presumably his wife did, too, since she had nothing to do with the business decisions); this the Commissioner concedes. (Comm's Br. p. 32.) But in our opening brief we set out in detail (pp. 35-45) and at length twenty different considerations which, on the basis of the undisputed record and evidence

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[1]The Commissioner's real or intentional misconception of this basic argument is illustrated by the statement that "investment" is a "misnomer" here (Comm's Br. p. 32, fn. 4; see also pp. 33-34) because Artcraft constructed the duplexes with borrowed money. But taxpayers received this property as a taxable dividend in kind from Artcraft, and therefore obtained a tax basis in the property. [R. pp. 23, 72.] Thus, even factually the Commissioner is wrong. But "investment," when used in connection with Section 117(j), does not refer to a monetary outlay, as the Commissioner either knows or should know. As this Court stated in *Rollingwood, supra,* page 267, footnote 5, "The word investment does not appear in the statute but is frequently referred to by the courts. * * *" The reason that word is used as a synonym for the statutory language, as this and other courts have repeatedly stated, is that property acquired to produce income is afforded capital gain; while property *bought for the purpose of resale—i. e.,* stock in trade, does not qualify for preferential taxation. The former is conveniently called an investment to distinguish it from the latter. Obviously, an "investment" does not become stock in trade even when one borrows the money to buy the property.

makes this case as strong as is possible and requires a finding that all the taxpayers *acquired* and *held* the property for investment—*i. e.,* for the production of income until it would be sold, as sooner or later occurs with all investments.

To answer this the Commissioner (Br. pp. 32-33) merely repeats the erroneous conclusion of the Tax Court, as proof of the very question raised by this appeal. But recognizing that this might not satisfy this Court, the Commissioner, apparently in the alternative, predicates his argument (Br. p. 33) on the assumption that the property was acquired as an investment by *all* the taxpayers.

Because the Tax Court found an investment purpose for Pool and perhaps his wife, yet taxed them the same as the Murphys, and since in any event the record requires the same conclusion as to the Murphys' Investment purpose, which the Commissioner made no attempt to rebut,[2] we think at this juncture of the case the Court must approach the case with the premise that all the parties had an original investment purpose.

3. The Commissioner argues (Br. p. 33) that, assuming the existence of a purpose of acquiring and holding for investment purpose, the Tax Court's ultimate conclusion that the property was held primarily for sale

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[2]Omitted also from the Commissioner's brief is any attempt to justify the Tax Court's arbitrary and capricious failure to give credence to Murphy's unimpeached, uncontradicted, straightforward and everywhere corroborated testimony. This error below, in itself, requires reversal of the Tax Court. *Grace Bros. v. Commissioner,* 173 F. 2d 170 (C. A. 9); *Chesapeake & Ohio Railway Company v. Martin,* 283 U. S. 209, 216, 217; *San Francisco Association for Blind v. Industrial Aid for the Blind, Inc.,* 152 F. 2d 532 536 (C. A. 8); *Foran v. Commissioner,* 165 F. 2d 705 (C. A. 5); *Ross v. Commissioner,* 227 F. 2d 265 (C. A. 5). See also *Herbert v. Riddell,* 103 Fed. Supp. 369, 388, 389.

is nevertheless correct because taxpayers impliedly concede the correctness of those findings when we stated (Br. p. 45) that "once a decision to sell is made the property is of necessity *held* for sale."

But the language quoted by the Commissioner from our opening brief was immediately preceded by the statement (Op. Br. p. 45), "The purpose of Section 117(j) as previously emphasized[3] is to permit the *sale* of investment property." The sentence quoted by the Commissioner was followed by the sentence (Op. Br. p. 45), "The statutory prohibition is not holding for sale but rather to *taxpayer's* 'customers' in the 'ordinary course' of *his* business."

The Commissioner's position, as we read his brief, is that a taxpayer's original purpose in acquiring and holding property as an investment is not relevant because, as soon as the taxpayer decides to sell it, this property is held for sale. This approach, of course, gives no meaning to the statute and has been repudiated time and again by the Courts of Appeals. (See our Op. Br. pp. 30-31.)

It is this erroneous view of the section that led the Tax Court to emphasize its finding that beginning with the employment of Boland the property was held for sale to customers [R. p. 70] and explains its failure to find anything at all about the original purpose of the acquisition of the property. This fundamental error illustrates, too, the point we stress, *supra,* that the Tax Court and the Commissioner merely emphasize some facts and omit others, without regard to the Congressional purpose or statutory standards which are a *sine qua non* to any intelligible application of Section 117(j) to a given set of facts.

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[3]Opening Brief, pages 28-32.

4. The Commissioner argues (Br. p. 34) that taxpayers do not qualify for Section 117(j) treatment because "taxpayers were under no compulsion, economic or otherwise, to liquidate their interest in Tracts 11451 and 13163." The brief continues that liquidation "connotes the absence of a motive to profit from sales * * *" citing *Camp v. Murray,* 226 F. 2d 931 (C. A. 4), and *Goldberg v. Commissioner,* 223 F. 709 (C. A. 5). Neither case remotely supports this astounding proposition. The purpose of Section 117(j), in the words of this Court, is to "alleviate the burden on a taxpayer whose property has increased in value over a long period of time from having the profits from sales taxed at graduated tax rates designed for a single year's income. The purpose is to protect 'investment property' as distinguished from 'stock in trade,' or property bought and sold for a profit. * * *" *Rollingwood v. Commissioner, supra,* pp. 266-267. It is manifest nonsense to say, as the Commissioner does, that if one is forced to liquidate or must sell at a loss, Section 117(j) applies, but if reasons exist which in taxpayer's business judgment make it desirable to liquidate an investment at a profit, then appreciation in value of the investment even over many years will be taxed in one year at graduated ordinary income rates which are often confiscatory. The statutory purpose was to prevent exactly this. Or, as the Court of Appeals for the Third Circuit stated only last year in *Curtis Company v. Commissioner,* 232 F. 2d 167, the sale of investment property to invest in something else "is precisely * * * [the] sort of thing which prompted the passage of the capital gains provision. Capital gains were taxed at lower rates to relieve the taxpayer from 'excessive tax burdens on gains resulting from a conversion of capital investments.

and to remove the deterrent effect of those burdens on such conversions.' *Burnett v. Hormel,* 1932, 287 U. S. 103, 106 * * *" To the same effect is *Corn Products Ref. Co. v. Commissioner,* 350 U. S. 44, 52.

But even if the courts had not passed on this point time and again, and even if the statutory purpose were less apparent, the proposition that liquidation of property connotes "the absence of a motive to profit from sales" (Comm's Br. p. 34), is patently contrary to the plain unambiguous meaning of liquidation which, of course, simply means to make liquid—*i. e.,* to convert to cash. One may liquidate because of pressure of creditors, or because the investment is unsatisfactory or, indeed, as here, to realize on the appreciation in value in order to make a different investment with the objective of securing more income. There could be hundreds of other reasons. If profits could not be realized on liquidation of investment, there would have been no need for Section 117(j).

5. The Commissioner correctly states our position that a liquidation of an investment can take place in such a way as to constitute a business. (Op. Br. p. 55; Comm's Br. p. 35.) But we do not "concede" this point, with its connotation that it is damaging to our position. On the contrary, we affirmatively assert this proposition because it is on this point that the Commissioner and the Tax Court confusedly marshal an odd assortment of facts to come to the conclusion that these taxpayers are not entitled to the remedial provisions of Section 117(j).

Thus, the Commissioner asserts (Br. p. 35) that "There can hardly be any dispute as to the correctness of * * *" the finding that the duplexes were held for sale in "a 'business of selling real estate' and were sold

to customers in the ordinary course of that business." We showed in our opening brief that there not only is a dispute but that there is no support for the finding that taxpayers' contract with Boland placed them in the business of selling houses in the ordinary course of their trade or business. (Op. Br. pp. 44-55.) These arguments remain ignored. Instead, the Commissioner marshals two printed pages of alleged facts without once indicating why the particular facts support its ultimate conclusion. For example, the circumstance is repeatedly referred to, that the taxpayers agreed to furnish office facilities, including a telephone, and that Boland conducted his selling activities from the office which taxpayers owned located in the center of Tract 11451. (Comm's Br. pp. 35-36.) As pointed out in our opening brief (pp. 50-51) Artcraft's office was used because it was the only office space available in that area. Obviously, it was desirable to have the sales operations with some degree of proximity to the extensive properties being sold. The purpose of taxpayers and Boland alike was to dispose of the property efficiently and as rapidly as possible. The use of Artcraft's office, for which suitable adjustment in the sales commission was made, was to the economic benefit of everyone concerned. But how did this put taxpayers in a new business of selling houses to customers? The absurdity of the Commissioner's position is apparent when he seriously argues that this is a relevant fact in determining whether a tax deficiency in excess of half a million dollars is to be upheld.

The fact that Boland advertised the property and put up sales signs is consistent with the purpose for which he made his contract with taxpayers, which was, of course, to sell the houses. The record is very clear and the Tax

Court made no finding to the contrary, that the advertising was prepared by Boland and he paid for it. This is consistent with a business being conducted by Boland, but not by the taxpayers. The only sensible way in which the large quantity of investment duplexes could be sold was by having that fact brought to the attention of the public.

The frequency, continuity and substantiality of the sales which the Commissioner emphasizes (Comm's Br. p. 36) is a necessary corollary of having 170 buildings to sell. The cases have repeatedly held that the large investor is not to be discriminated against because of the size of his holdings. In our opening brief (p. 46) we cited *Curtis Company v. Commissioner, supra,* in which 1098 rental units were disposed of in the tax years; *Chandler v. United States,* 226 F. 2d 403 (C. A. 7), where 290,000 acres of land were disposed of in 536 separate transactions in eight tax years; and *Ross v. Commissioner,* 227 F. 2d 265 (C. A. 5), where the court said (p. 268) that the only significance of large numbers is that taxpayer "had a lot of houses to sell * * *"

It is significant, we believe, that these cases all involve reversals of the lower courts, all were decided subsequent to the decision below, and not one is deemed worthy of mention in the Commissioner's brief. Moreover, he filed no petition for certiorari in the Supreme Court.[4]

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[4]The Commissioner's failure to petition for writs of certiorari in these cases is highly significant. If, as the Commissioner asserts here, the ultimate question is one of fact (see point 9, *infra*), then, under the Government's view, the *Curtis* case, *supra,* for example, must have been erroneously decided for the facts there (which the Commissioner deems relevant) were stronger for his position than the facts here. And if the Commissioner's "fact question" approach is correct, the *Curtis* case would have been in

6. The Commissioner's argument that there was a business conducted by taxpayers in which they held property primarily for sale to customers (Comm's Br. pp. 32-38), necessarily overlaps his argument that the business was that of taxpayers, not Boland's. (Comm's Br. pp. 38-43.) And, indeed, under the latter heading we find the Commissioner again listing all of the facts asserted in the prior argument, and some additional facts, again with no explanation as to why they have relevance. We emphasized in our opening brief that in *Curtis Company* the Commissioner conceded in open court that had a broker there been employed, Section 117(j) would be applicable. Despite this admission where he thought it aided his case, here he argues the opposite in an attempt to win a case regardless of principle and regardless of merit.

Without shedding any light on the logical solution to the present controversy and for all that appears solely for the purpose of beclouding the issue, the Commissioner grudgingly states that although Boland was a licensed real estate broker (p. 39), "so far as appears, he had no office in the Los Angeles area and was not even permanently located there." While the record does not expressly state that he was permanently located here, the fact is that he was and still is. But the question we would like to ask is, what difference does it make whether he was or was not? Furthermore, what difference does it

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conflict with the decision of other circuits which the Commissioner cites here as supporting his approach. Consequently, the failure to ask for Supreme Court review, particularly where as in *Curtis* a much larger tax was involved than here, strongly suggests that the Commissioner saw no conflict in decisions and conceded that the Third Circuit was correct when it held that the Tax Court had committed reversible error in failing to apply Section 117(j). As we show, the same conclusion is *a fortiori* required here.

make that he tried to get 5 per cent commission but taxpayers agreed to pay him $500 per house? (Comm's Br. p. 40.) What difference does it make if the deeds used in the sale of the duplexes were drawn up by the taxpayers' attorney? (Comm's Br. p. 40.) The deeds obviously had to be prepared by someone, and the owner of the property customarily has the deed prepared, because he is the one who executes it.

The controlling facts are that taxpayers entered into two separate contracts with Boland, first to sell the 70 duplexes and then the 100 duplexes, and except for the signing of the deeds and the incidental assistance of Murphy with respect to securing financing for the purchase of the 100 duplexes by customers, when he spent a few days with Boland helping to find a lender, taxpayers had nothing whatsoever to do with these sales. There are no reported cases in this field where the taxpayers exhibited less activity in selling than did these. If this constitutes the "everyday operation of a business" rather than the conversion of a capital investment which, at least until the decision to sell had been made, it clearly was, we think the standards of the statute are being ignored.

As the Supreme Court stated in its most recent pronouncement in the capital gain area, in *Corn Products Ref. Co., supra,* "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income. * * * The preferential treatment * * * applies to transactions in property which are not the normal source of business income." The court concluded, as this and other courts have constantly done, that Congress intended to relieve "excessive tax burdens on gains resulting from a conversion of capital investment. * * *" We do not believe that,

on the present record, any conclusion is permissible except the conclusion that the taxpayers were not deriving income from the operation of a business.

7. We do not deny that frequency and continuity of sales, the amount of advertising, and various other factors are important criteria in proper situations. But the Commissioner, failing to comprehend why these standards are material in some cases and not in others, puts an irrelevant emphasis on these criteria in the present case.

There have been three types of cases in this general area in which a taxpayer is taxed with ordinary income, and properly so.

(1) In some cases, the question of original intention is obscure; in determining whether that intention was one of investment or sale, a court may properly look at the frequency and extent of *buying* and selling to determine whether the taxpayer was an investor or one who bought and sold in order to make a profit. Such cases in this court were *Rollingwood v. Commissioner, supra; Homann v. Commissioner,* 230 F. 2d 671; and *Cohn v. Commissioner,* 226 F. 2d 22.

(2) In some situations, although the original property had been acquired for use in the trade or business, or for an investment purpose, the taxpayer altered the character of the property in order to sell it at the highest possible price. Examples of such cases in this court are *Richards v. Commissioner,* 81 F. 2d 369, in which property used for truck farming was subdivided into residential lots, and improved by the construction of streets, gutters, and the bringing in of utilities such as gas, electricity and water. Although the taxpayer em-

ployed a broker, this court correctly found that taxpayer was not within the statute because the property which he was selling—the residential lots—was no longer property (farm land) used in the trade or business. *Ehrman v. Commissioner,* 120 F. 2d 607, (C. A. 9), was a similar case. Another case in this category in this court is *Commissioner v. Boeing,* 106 F. 2d 305, where the investment property had been timber lands, but the gain in question was derived from cutting timber and delivering the logs for sale. The property sold then was not the investment but property which the taxpayer had imparted additional values when the logs were cut and delivered in a salable form.

(3) The third category of situations and, admittedly, the one that gives the most difficulty in this field, is where there is an original investment purpose and there is a later decision to sell, but the sales are so frequent and continuous over so long a period of time and the activity of the taxpayer is so extensive that some courts have held that this, itself, constitutes a trade or business. We do not think we would be properly exercising our responsibility to this Court if we were to conclude that all in this field is black or white (as one might gather from the Commissioner's brief) because, as is frequent in the judicial process, particularly in the application of taxing statutes, a little gray often creeps in.

Conceivably, there can be situations where a taxpayer so busies himself in selling his property that he puts himself into a business of selling to customers. But since, as we have shown, Section 117(j) would be meaningless if it denied capital gain to a taxpayer who sold his investment as expeditiously as possible, it should take an extreme situation to warrant a conclusion that a taxpayer who is selling

his investment has become occupied with a business in doing so. Indeed, despite the fact that large amounts of property may be involved and despite extensive activity on the part of taxpayers in selling that property, the weight of authority holds that taxpayers are entitled to capital gain since otherwise the Congressional purpose expressed in Section 117(j) would be thwarted. Illustrative of this point are two cases decided only last year—*Curtis Company v. Commissioner,* 232 F. 2d 167, and *Chandler v. United States,* 226 F. 2d 403.

In the present case, we believe it is clear error to conclude, as the Tax Court did, that the taxpayers became engaged in a business once they decided to sell the property. We submit that the activities of these taxpayers were the very minimum possible to effect an orderly liquidation of the large number of duplexes which they own. The properties were disposed of in a short period of time, and with the minimum personal activity on their part. In short, this case is a typical situation in which Congress intended that the tax relief afforded by Section 117(j) should be applied.

It will be noted that the Commissioner, without any attempt at analysis, relies on authorities which deal with the first two categories of situations which we have mentioned. Those cases, quite obviously, do not support his conclusion that the present taxpayers, who had an original investment purpose and who did not attempt to change the character of the property, became engaged in a business merely by selling their investment property. Indeed, it is not amiss to observe that the Tax Court, like the Commissioner, has sometimes tended to indulge in an indiscriminate reliance on precedents which deal with categories (1) and (2) in situations which really

fall within category (3); this failure of the Tax Court to make a proper analysis of cases lying within category (3) has led to the reversal of its decisions, as often, or more often, than they have been affirmed. And we emphasize the number of reversals subsequent to the decision in this case. See cases cited in Opening Brief, page 24.

8. In view of the indefensible position that the Commissioner here takes it is not surprising that it seeks to take refuge in the proposition that there is no question of law for this Court to pass on. (Comm's Br. pp. 30-31.) We pointed out in our opening brief (pp. 23-27) that the applicability of Section 117(j) presents, at best from the Commissioner's viewpoint, an ultimate question of fact which itself involves the legal significance of evidentiary facts, and is, accordingly, "subject to review free of the restraining impact of the so-called 'clearly erroneous' rule." *Lehmann v. Acheson,* 206 F. 2d 592, 594 (C. A. 3); *Baumgartner v. United States,* 322 U. S. 665, 670, 671; *Galena Oaks Corp. v. Scofield,* 218 F. 2d 217, 219 (C. A. 5); *Curtis Company v. Commissioner, supra;* 5 Moores' Federal Practice, 2d Ed., Sec. 5203(3); *Cf.,* this court's decision of February 28, 1957, in *Earle v. Woodlaw* on an analogous issue under Section 115(c) and 115(g) of the Internal Revenue Code of 1939. Characteristically, the Commissioner's brief meets this issue by ignoring all of the authority which we cite.

But we see no reason to attempt to lead this Court into a semantic labyrinth on the distinction between law and fact, because even if the "clearly erroneous" standard is applicable, the case must be reversed. The meaning of that phrase as stated by the Supreme Court in *United*

States v. United States Gypsum Co., 333 U. S. 364, 395, is simply that "A finding is 'clearly erroneous' when although there is evidence to support it the reviewing court on the entire evidence is left with a definite and firm conviction that a mistake has been committed."

Judged by that standard we confidently submit that this case should be reversed.

June 10, 1957.

Respectfully submitted,

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